

What a Quarter!

Presidential candidate Barack Obama promised us change, and it appears President Obama is indeed fulfilling his campaign promise. The government has a significant ownership position in the nation's largest financial institutions; his administration is dictating company policy at Chrysler and General Motors; he, Congress, the Treasury, and the Fed have poured more than \$3 trillion dollars into a sick economy and financial system; he has proposed universal health care, a high speed rail system, and elimination of the Bush tax cuts set to expire at the end of 2010; and his projected budget short-fall during the next 10 years is of epic proportions. Meanwhile, the financial markets have begun to thaw, the number of unemployed in the labor force has swelled beyond 6 million, the unemployment rate is steadily on track to hit 10%, housing starts have hit historic lows (currently an average of about 1,000 homes a month for each state in the Union), and bankruptcy filings (both personal and business) continue to spike.

During the quarter we took several calls from private clients wanting to know if they should dump all of their stocks and park the proceeds in money market funds or short-term Treasury securities. Television pundits were regularly brought on-air calling for investors to head for the exits. This sentiment reached its peak during the second week of March when the market averages breached their November lows. To us, that was the signal of an impending stock market rebound. From the November 9th low to mid-April the Standard & Poor's 500 Index rose 30%, emerging markets rose 37%, and the Russell 2000 spiked 38%

So, where does the market go from here? First, if anyone tells you they know where the stock market is headed, RUN. That being said, like

the tulip bulbs we planted last year, we are beginning to see some sprouts of economic activity poking their noses upward this spring. Modest upticks in consumer confidence, automobile sales, retail sales, and a significant slowdown in the rate of expansion in new unemployment claims are giving us



Dr. Gerald Perritt
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hope that the economy will stabilize during the third quarter and head modestly higher during the fourth quarter. Like a supertanker, the decline in Gross Domestic Product ("GDP") must first slow before it stops and begins to head in another direction.

We don't believe that the stock market's 30% rebound between March 9th and mid-April is the beginning of a new secular bull market. Instead, the rebound was a snapback from an overly depressed level. At Dow 8000, the 5-week surge basically recouped the loss it sustained during the 5-week period between the end of January and March 9th. The rebound aside, the stock market itself is showing a few sprouts. We have seen a pickup in corporate buyouts, and the suitors are paying cash. We have also seen a handful of successful IPOs hit the market and trade at significant premiums in the secondary market. Finally, there is plenty of cash around to fuel a sustained bull once it begins. According to the Investment Company Institute, there is currently nearly 4 trillion dollars invested in money market funds.

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With the expansion in the money supply, there is plenty of talk about impending inflation and a sinking dollar. We don't see either on the near-term horizon. First, despite the Fed and Treasury actions, the value of the dollar has actually gained ground against the euro, pound, and yen. That's because many countries in the world are in worse shape than the U.S. at this point in time. Furthermore, we believe that the U.S. economy will turn upward before Europe and Japan. Thus, we look for the value of the dollar to stabilize near current levels. As for inflation, remember that there are 6.1 million people out of work in the U.S. and capacity utilization has fallen below 70%. Thus, there is plenty of slack in the economy, which needs to be siphoned off before inflation pressures become a problem. The hope is that the government can slowly reverse its expansionary course once the economy begins to head upward.

My call for a stock market bottom in November missed the mark. When I made this call last September, I didn't

realize how bad the credit crisis had become. Thus, I am hesitant to call the March 9th low the ultimate bottom, though it sure feels like it. My guess is that the market will muddle along during the summer and could begin a sustained rally in the fall. Our friends at *Investors Intelligence* have pointed out that since 1950, holding the Dow Jones Industrial Average between May 1 and October 31 has resulted in a loss, and that is after a 58 year period.

That being said, we are still seeing extremely attractive valuations in the smaller company segment of the market. Business is bad, but there are plenty of companies around that are still generating cash, have plenty of cash on their balance sheets, and possess minimal amounts of long-term debt. That is also true in the mid-cap and large-cap space. Remember, corporate America has cut its labor, production, and distribution costs. Once the economy turns, corporate earnings could explode as operating leverage and greater efficiencies send increased revenues straight to the bottom line.

2009 1st Quarter Financial Market Statistics

Commodities		Foreign Markets		U.S. Industry Performance	
Gold	+6.2%	U.K. FTSE 100	-11.5%	Basic Materials	-5.5%
Corn	+0.3	DAX	-15.1	Consumer Goods	-11.4
Cattle	-9.0	CAC 40	-12.8	Consumer Services	-7.1
Soybeans	-1.0	Japan	-8.5	Financials	-27.7
Silver	+21.5	Hong Kong	-5.6	Health Care	-8.0
Wheat	-8.0	India	+0.6	Industrials	-19.5
Platinum	+25.1	China	+37.9	Oil & Gas	-10.6
Oil	+11.3	Mexico	-15.3	Technology	-4.8
CRB Index	-5.1	Brazil	+9.1	Telecomm	-3.3
		Argentina	+4.3	Utilities	-12.2
U.S. Stocks		U.S. Dollar vs.		Bond Yields (quarter end)	
Dow Industrials	-13.3%	Euro	+5.1%	30-yr T-bond	3.56%
Nasdaq Composite	-3.1	British Pound	+1.5	10-yr T-bond	2.71
Nasdaq 100	+2.1	Canadian Dollar	+3.8	3-mo T-bill	0.21
S & P 500	-11.7	Yen	+9.0		
Russell 2000	-15.4				
Wilshire 5000	-10.7				

Past performance is no guarantee of future results.

Source: Yahoo Finance



The Death of Small Firm Stocks Another Exaggeration

There’s nothing like a severe bear stock market to spawn some of the worst advice financial pundits can offer. Given that this bear market is the worst in memory (very few of today’s investors remember the great bear market of the 1930s), some of the worst advice we have ever heard is spewing from the talking heads on financial “news” programs.

With most stock market indexes sporting 10-year declines, a growing number of pundits are telling us that a buy-and-hold strategy is doomed to failure and that profit-seeking investors should opt instead for an active trading strategy. We have been told that bonds will outperform stocks during the remainder of this decade and the next. The advice: abandon equities and head instead for better yielding bonds. We have heard that exchange traded funds should be avoided because the stock market will provide suboptimal returns for the next decade. The advice here is to avoid market replicating portfolios in favor of highly concentrated portfolios whose returns are uncorrelated with market performance.

We have also been told that after such a catastrophic decline in stock markets around the world and in the ongoing economic recession (depression?) we should avoid the shares of small company stocks and the mutual funds that invest in them and opt instead for the shares of giant cap firms. The reasoning here is that small companies are undercapitalized, are burdened with debt that can’t be refinanced, and lack the management sophistication to navigate a perilous economic environment. While this description is no doubt true for some companies in the small-cap and micro-cap segment of the market, the description also holds true for a number of large-cap and giant-cap companies as well. (In fact, we could argue that the current economic disaster was created by giant-cap companies painted with this descriptive brush.)

It is somewhat understandable why advisors have been telling investors to avoid small-cap stocks and to pack their portfolios with the stocks of large and giant companies. With the stock market near a 12-year bottom, investors have seen the value of their nest eggs cut in half. The reasoning behind the “avoid small company” advice is that investors need to reduce the risk of their equity portfolios in order to allow them to stay in the market longer term. However, that advice is akin to someone

telling you that you should purchase homeowners insurance now that you house has burnt to the ground.

We are small-cap and micro-cap investors, and like most investment pros we are biased toward our chosen investment category. However, we believe we are also prudent financial professionals and are constantly telling anyone who will listen that an all-cap strategy is best for equity investors. That being said, we also believe that shunning small company stocks after a catastrophic stock market meltdown is one of the biggest mistakes an equity investor can make.

First, the performance record for small company stocks is not nearly as bad as conventional wisdom indicates. Check out the accompanying table. It lists the compound annual investment returns provided by small company stocks during each of the last eight decades. I am sure that you are surprised to learn that during every one of these decades (including the partial decade bounded by 2000 and 2008) small firm stock produced positive average annual returns.

Small Company Stocks Compound Annual Returns by Decade

1930s	1.4 %
1940s	20.7
1950s	16.9
1960s	15.5
1970s	11.5
1980s	15.8
1990s	15.1
2000s*	4.1

* Based on the period 2000-2008

Source: Ibbotson 2009 Classic Yearbook
Past performance does not guarantee future results.

We have pointed out in previous issues of this newsletter the fact that when the stock market rebounds from a severe bear market , the stocks of smaller companies have historically performed best both in terms of absolute returns and in returns relative to those of larger company stocks. The reason has nothing to do with the quality of

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What Now Dow?

The Dow Jones Industrial Average, the “Dow,” was created by American journalist Charles Henry Dow on May 26, 1896. The Jones part was named after Dow’s business partner Edward Davis Jones, a statistician. Interestingly, Jones didn’t have anything to do with creating the stock index. Dow compiled the index to gauge the performance of the industrial sector of the American stock market. It is the second-oldest U.S. stock market index, after the Dow Jones Transportation Average, which Dow created 12 years earlier.

The Dow was created to help investors’ view trends in the stock market and disseminated daily in Dow’s publication, *the Customers’ Afternoon Letter*. Dow and Jones partnered with Charles Bergstresser in the financial news business. They opened their shop in the basement of a lower Manhattan candy store that eventually became home to the New York Stock Exchange. *The Customers’ Afternoon Letter* later became the *Wall Street Journal*, the first edition of which contained 4 pages and sold for 2 cents. The first day’s closing average of 12 stocks was 40.94. Two-and-a-half months later, on August 8, 1896, the average had tumbled to 28.48, which was the lowest point on record for the Dow. Of the 12 original companies included in the average, only General Electric remains today.

Over the years, the Dow Jones Industrial Average evolved into a blue chip average of the largest companies in America. The phrase “blue chip” to describe high quality stocks was coined by a Dow Jones employee (Oliver Gingold) in the 1920s. Gingold noted that the highest value poker chips were colored blue applied that color to the highest value companies whose stocks were listed on the NYSE. When Charles Dow dies in 1902, Clarence Barron, originally hired as a correspondent, purchased a controlling interest in the firm.

Originally, the Dow was computed as a simple average of the share prices of its 12 component companies. However,

as time passed adjustments to the Dow were required to adjust its value to account for stock splits, stock dividends, and a changing composition. For example, when a company split its stock, its stock price would fall by an amount equivalent to the reciprocal of the split. Although the value of the company would remain after the split (a lower share price but more shares outstanding), the value of the Dow would decline because of the price decline. To adjust for these events, the divisor of the Dow would be reduced by an amount that would leave its value unchanged. Today (05/01/09), the Dow’s divisor stands at 0.125552709. Thus, the impact of a \$1 change in any of its 30 components caused the “Average” to change by 7.97 points.

Although the Dow is the most quoted market measure, very few professional investors use it as a benchmark to judge portfolio performance. First, unlike most other indexes of stock market performance (e.g., Standard & Poor’s 500, Wilshire 5000, Russell 2000, etc.) that are market value weighted, the Dow is price weighted. That is, the stocks with the highest price impact the Dow the most. For example, a \$1 change in the share price of IBM (currently trading around \$100 a share) causes an 8 point

change in the Dow as does a \$1 change in the share price of General Motors (currently trading around \$2 a share). Thus, a 1% move in one stock can cause the same move in the Dow as a 50% move in another stock.

Second, professional investors believe that the Dow is much too narrow to be a reliable gauge of stock market performance. Of the 5,000 or so publicly

traded stocks with national exposure, it contains the stocks of 30 companies, which represents less than 1% of the nationally traded stock universe. Finally, the Dow Jones Industrial Average is not really an average of industrial

Dow Jones Average Milestones

First close over 100	Jan 12, 1906
First close over 1,000	November 14, 1972
First close over 5,000	November 1995
First close over 10,000	March 29, 1999
Lowest close 28.48	August 8, 1896
Record close 14,164.53	October 9, 2007
Divisor falls below 1.0 for the first time (0.956) as a result of a 2-for-1 Merck stock split on May 27, 1986	
Largest daily point loss 778 points on September 29, 2008	
Largest daily point gain 936 points on October 13, 2008	
Largest daily percentage decline 22.6% on Black Monday October 19, 1987	
Largest daily percentage gain 15.3% on March 15, 1933	

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Investing In Smaller Companies Since 1987



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stocks. Four of its components (American Express, Bank of America, Citigroup, and JPMorgan Chase) are financial services firms and three others (Home Depot, McDonald's, and Walmart) have been drawn from the retail sector.

The keepers of the Dow are a panel of Wall Street Journal Editors who decide which companies go in and out of the Dow. Their goal is to keep the Dow representative of American industry. Interestingly, they have had a notoriously bad track record when it comes to making changes. For example, they kicked Chrysler out of the Average when its stock hit bottom in the late 1970s, only to miss its subsequent robust share price rebound. They added Intel and Microsoft in November 1999, shortly before technology stocks nosedived. They added AIG in 2004 when it was a darling of Wall Street and removed it when bankruptcy loomed in 2008. Interestingly, the Average was expanded from 20 to 30 stocks in 1928, near the height of the "roaring 20s" bull market. Although we are not sure when the

next changes will occur, rumor has it the both General Motors and Citigroup will soon be departing.

The Dow Jones Industrial Average appreciated at a 5.3% compound annual rate during the 20th Century, a record Warren Buffett called "a wonderful century." According to Mr. Buffett's calculations, to achieve that return again, the index would need to reach nearly 2,000,000 by 2100. So far, the 21st century has not treated the Dow very well. The current credit crisis and resulting economic recession have exacted a heavy toll on the Average. It was trading above 14,000 shortly before the current recession began in late 2007 and nosedived 7,700 points by early March 2009. Three of its current components are in deep financial trouble (Bank of America, Citigroup, and General Motors). Interestingly, if the prices of the stocks of these three companies were to suddenly fall to zero simultaneously, the impact on today's Dow would be a decline of 134 points, a drop of a mere 1.7 percent.

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small firm stocks relative to the quality of large firm stocks. Instead it is liquidity that calls the tune. Smaller company stocks tend to perform worse than large cap stocks on the way down because they are less liquid. Selling of stocks across-the-board by fearful investors sends the prices of small company stocks markedly lower as market makers step away from the market. Each successive round of selling hits market makers' bids that become progressively lower. The reverse is true during a market rebound. Incremental buying pressure takes out market makers' asking prices and the lack of other willing

sellers causes the share prices of smaller company stocks to soar. In short, small cap stocks have performed best during stock market rebounds because they were overly depressed when the market ultimately hit its bottom.

The quality of a company has nothing to do with size. Like all stocks, quality depends on financial condition, management expertise, the ability to deliver quality goods and services, and cost containment. And these are attributes are not confined to the large-cap and giant-cap sectors of the market.

Panics, Recessions, and Depressions

Ever wonder how "The Great Depression" got its name? President Herbert Hoover, the man blamed by many for causing the Great Depression of the 1930s, also helped name it.

During this country's 233-year history, there have been many periods marked by falling commodity and financial asset prices, and plummeting economic output. The downturns were generally known as "panics," but Hoover deliberately chose the word depression because he

thought it sounded less alarming, according to historian William Manchester.

Hoover even used these words in a speech in the fall of 1931: "I need not recount to you that the world is passing through a great depression." But his use of "a" instead of "the" was an indication that Hoover did not grasp the historical significance of the economic troubles. It fell to Lionel Robbins, a British economist, to write a book that would give a name to the times, *The Great Depression*.

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Past performance is not a guarantee of future results. Index performance is used for illustrative purposes and not indicative of fund performance. You cannot invest directly in an index. Please visit www.perrittmutualfunds.com for fund performance.

The fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and it may be obtained by calling 800-331-8936 or by visiting www.perrittmutualfunds.com. Read it carefully before investing.

Mutual Fund Investing involves risk. Principal loss is possible. Investments in smaller companies involve additional risks such as limited liquidity and greater volatility than larger companies. Investments in micro cap companies tend to perform poorly during times of economic stress. The funds may invest in early stage companies which tend to be more volatile and somewhat more speculative than investments in more established companies.

The S&P 500 Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. The Dow Jones Industrial Average is an unmanaged index of common stocks comprised of major industrial companies and assumes reinvestment of dividend. The NASDAQ Composite Index is a market capitalization-weighted index that is designed to represent the performance of the National Market System which includes over 5,000 stocks traded only over-the-counter and not on an exchange. Nasdaq 100 Index an index composed of the 100 largest, most actively traded US companies listed on the Nasdaq stock exchange The Russell 2000 Index consists of the smallest 2,000 companies in a group of 3,000 U.S. companies in the Russell 3000 Index, as ranked by market capitalization. The Wilshire 5000 Stock index consists of more than 5000 companies, representing virtually all of the capitalization of the entire U.S. stock market. FTSE 100 is an index of the share prices of the 100 largest companies in the UK. The CAC-40 Index is a narrow-based, modified capitalization-weighted index of 40 companies listed on the Paris Bourse. You cannot invest directly in an index.

Top Ten Holdings as of 3/31/09: PRCGX – Star Gas Partners (2.09%), Comfort Systems USA (2.08%, Universal Electronics (1.97%), Bioscrip (1.92%), Flanders (1.695), Harmonic (1.59%), Perma-Fix Environmental Services (1.59%), Bakers Michael (1.55%), Barrett Business Services (1.52%), Rimage (1.52%); PREOX – Perma-Fix Environmental Services (2.16%), Versant (1.88%), Clicksoftware Technologies (1.79%), Espey Manufacturing & Electronics (1.71%), American Software (1.64%), White Electronic Design (1.60%), North American Galvanizing (1.60%), Monterey Gourmet Foods (1.59%), Birner Dental Management (1.58%), California Micro Devices (1.55%). Fund holdings and sector allocations are subject to change at any time and are not recommendations to buy or sell any security.

Current and future portfolio holdings are subject to risk.

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